

ANALYSIS OF ORIGINAL BILL

Author: Plescia Analyst: Nicole Kwon Bill Number: AB 955
 Related Bills: See Legislative History Telephone: 845-7800 Introduced Date: February 22, 2007
 Attorney: Douglas Powers Sponsor: _____

SUBJECT: Qualified Small Business Investment Credit

SUMMARY

This bill would create a tax credit for investing in a qualified small business.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to assist small businesses by providing a state income tax credit to taxpayers that invest in small businesses.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and, by the specific terms of the bill, operative for taxable years beginning on or after January 1, 2007, and before January 1, 2015.

POSITION

Pending.

ANALYSIS**FEDERAL/STATE LAW**

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Current federal law provides general business credits such as the investment credit, the work opportunity credit, and the empowerment zone employment credit.

Board Position:

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Department Director

Date

Selvi Stanislaus
by Lynette Iwafuchi

4/19/07

Current state law allows a credit equal to 20% of each qualified deposit made by any taxpayer into a Community Development Financial Institution (CDFI). A qualified deposit is defined as a deposit that does not earn interest or an equity investment that is equal to or greater than \$50,000 and is made for a minimum duration of 60 months. A CDFI is defined as a private financial institution located in California and certified by the California Organized Investment Network that has community development as its primary mission and lends in urban, rural, or reservation-based communities in California. A CDFI may include a community development bank, a community development loan fund, a community development credit union, a microenterprise fund, a community development corporation-based lender, and a community development venture fund.

THIS BILL

This bill would provide, for each taxable year beginning on after January 1, 2007, and before January 1, 2015, one of the following credits to a qualified taxpayer that makes a qualified investment in a qualified small business: (1) in the case of an investment made with its principal place of business in a rural county meeting the requirement set forth in Section 40184 of the Public Resources Code or that is a bioscience enterprise, 12% of the amount of the qualified investment for the first and second taxable years and 11% of the amount of the qualified investment for the third taxable year, or (2) in the case of a qualified small business other than described in paragraph (1) above, 10% of the amount of the qualified investment for each of the first three taxable years beginning in the taxable year in which the investment is made.

This bill would limit the total aggregate amount of credit available to all qualified taxpayers to \$20 million for all taxable years.

This bill would limit the total amount of all qualified investments made by a qualified taxpayer and its affiliates to \$250,000 in any qualified small business.

This bill would limit the total amount of qualified investments made by all qualified taxpayers in a single qualified small business to an aggregate of \$2 million for all taxable years.

This bill would require the Department of Corporations to certify that the investment qualifies for the credit and the total amount of the credit allocated to the taxpayer. In addition, this bill would specify other rules the Department of Corporations is required to follow, among them providing to the Franchise Tax Board (FTB) all necessary information required to administer the provisions of this bill, and creating an annual listing of the taxpayers that were issued certificates, and notifying FTB of discovery of an applicant who received a credit certificate with misrepresented information on the application.

This bill would require the taxpayer to provide the substantiation, in the form and manner requested, to FTB that the investment is a qualified investment.

This bill defines a “qualified investment” to mean an investment in an equity security meeting the following requirements:

- The equity security is common stock, preferred stock, an interest in a partnership or limited liability company, a security that is convertible into an equity security, or other equity security as determined by the Department of Corporations,
- The amount of the investment is at least \$25,000, and
- The qualified investor and its affiliates do not hold equity securities representing more than 30% of the total voting power of the qualified small business.

This bill would define a “qualified small business” to mean a corporation, limited liability company, partnership, or other business entity, other than a sole proprietorship, that meets all of the following:

- Maintains at least a portion of its operations at an office or manufacturing or research facility located in this state,
- Has at least two principal full-time employees who are residents in this state, and
- Does not have a principal business involving any of the specified businesses identified in the bill.

This bill defines a “qualified taxpayer” to mean a taxpayer that meets all of the following:

- Makes a qualified investment in a qualified small business,
- Files an application with the Department of Corporations within 30 days after making a qualified investment,
- Provides written authorization to the Department of Corporations designating the department as eligible to receive tax information from FTB, and
- Files a state return claiming the tax credit with FTB by the due date of the return.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author’s office to resolve these and other concerns that may be identified.

This bill uses the term “principal business” that is undefined in the bill. The absence of a definition could lead to disputes between the department and taxpayers and would complicate the administration of this credit.

This bill specifies that a “qualified small business” must maintain “a portion of its operations” at an office or manufacturing or research facility located in this state. It is suggested that the author define or specify how to measure “a portion of its operations”.

This bill would limit the total aggregate amount of credit to all qualified taxpayers to \$20 million for all taxable years and limit the total amount of qualified investments made by all qualified taxpayers in a single qualified small business to an aggregate of \$2 million for all taxable years. The department would need to be notified when the limit for these aggregate amounts are reached in order to administer the provisions in the bill.

An aggregate of \$2 million limit for each qualified small business and \$250,000 limit for a qualified taxpayer could be interpreted as a total of \$4 million and \$500,000 because there is no distinction between the personal income tax law and the corporate tax law. The author's office may want to consider including a similar corporate tax law provision included under subdivision (d)(3).

On page 6, line 36, this bill uses the phrase "the credit allowed and claimed by the business or partnership." Generally, the understanding is that a partnership is a business. The author's office may want to eliminate "partnership" or to clarify if the author's intent is to allow the credit to be passed through a partnership that is not a business.

The use of the term "limited liability company" (LLC) in the bill would be problematic. Except for purposes related to the LLC tax and fee, for tax purposes, an LLC is treated as a corporation, a partnership, or in the case of a single owner, it is disregarded. To avoid possible disputes between the taxpayers and the department, the author's office may want to eliminate the term LLC or clarify what is intended for the tax classification of an LLC.

TECHNICAL CONSIDERATIONS

On page 2, line 4 and page 7, line 23, "be" should be placed between "shall" and "equal."

Tax credits are not issued, but claimed on a return by the taxpayers. On page 3, line 19 and page 8, line 38, "all tax credits that are issued" should be replaced with "all tax credits that are claimed."

On page 3, line 26 and page 9, line 5, "subdivision (b)" should be replaced with "subdivisions (c) and (d)" to refer to the correct limitation of the amount of investments in the qualified small business.

On page 6, line 2 and page 11, line 22, the "subdivision" should be replaced with "subparagraph."

This bill defines the term "qualified taxpayer" but not "qualified individual taxpayer." On page 6, line 33, "qualified individual taxpayers" should be replaced with "qualified taxpayer" to be consistent in the provisions.

LEGISLATIVE HISTORY

AB 2640 (Torrico, 2005/2006) would have provided a credit to qualified taxpayers that attain certain goals with regard to job creation and retention in California. AB 2640 was held in the Assembly Revenue and Taxation Committee.

OTHER STATES' INFORMATION

The states surveyed include *Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Although each of these states have economic development programs to encourage job growth, those programs are generally targeted to specific distressed areas or disadvantaged employees and are not comparable to the provisions of this bill.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this provision would result in the following revenue losses.

Estimated Revenue Impact of AB 955 Effective for Tax Years BOA 1/1/2007 Assumed Enactment Date After 7/1/07 (\$ in Millions)		
2007/08	2008/09	2009/10
-\$1	-\$3	-\$5

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The revenue impact of this bill is dependent on the number of taxpayers that invest in small businesses within California, the average amount invested, and the rate the credit for the investor is used to reduce tax liabilities. The revenue impact for this bill will focus on the bioscience industry and it is assumed that the allocated limit of \$20 million would be met at the first three-year phase of the investments.

According to the study on California's Biomedical Industry published by the California Healthcare Institute and PriceWaterhouseCoopers, there are about 1,500 small businesses within the biomedical industry in California. Assuming that 90% of these businesses would meet the small business qualifications of this bill, the number of qualified small businesses would total 1,350 (1,500 x 90%). Assuming that 15% or 203 (1,350 x 15%) small businesses receive a total of \$300,000 from at least three investors, allocated credits during the first three-year phase would exceed the \$20 million maximum $[(203 \times \$300,000 \times 12\% \times 2) + (203 \times \$300,000 \times 11\%) = \$21.2 \text{ million}]$. This estimate limits allocated credits to \$7.5 million during the first and second years and \$5 million during the third year.

Assuming that the certification process specified in the bill is in place by the end of 2007, \$7.5 million in credits allocated during calendar year 2008 are anticipated to be utilized over three years. Likewise, credits allocated during 2009 and 2010 for investments made during 2008 would be used over three years. The revenue estimate in the chart above reflects anticipated changes in estimated payments and the credit usage pattern.

LEGAL IMPACT

This bill would require taxpayers to maintain a portion of their operations in California to qualify for the credit. This requirement may be subject to constitutional challenge under the Commerce Clause of the United States Constitution.

This bill contains provisions that would target certain incentives to taxpayers that hire residents of California while denying the same incentive to taxpayers that hire employees in California who are nonresidents. The U.S. Supreme Court in *Lunding Et Ux. v. New York Appeals Tribunal et al.* (1998) 118 S. Ct. 766, found that denying a tax benefit to a nonresident taxpayer, while allowing such a benefit to resident taxpayers, was discriminatory and thus unconstitutional. Consequently, the qualified small business investment credit conditioned on employees with residency in California may be subject to constitutional challenge.

LEGISLATIVE STAFF CONTACT

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